JUNE 1991

MORTGAGE BANKING

THE JOURNAL OF REAL ESTATE FINANCE

THE SERVICING MARKETPLACE

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JUNE 1991 VOLUME 51 NUMBER 9

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Servicing Marketplace

Like a Middle Eastern marketplace, the offerings of the servicing market can be exotic at times. But the hot trading is in the basic goods—top quality agency servicing with low delinquencies. This issue seeks to explore some of the byzantine intricacies of how to package and price both the commonplace and the unusual that find their way to the servicing market.

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COVER PHOTOGRAPH BY PAUL TRUMMER / THE IMAGE BANK

Dizzying Dollars

Many, many packages have changed hands since the secondary market for servicing was created. The dollar figures are dizzying.

During the past 10 years, one of our authors speculates that perhaps as much as $1 trillion has changed hands. This is big business.

And the government is now the largest player in this grandiose enterprise.

How do you get the most for your wares using this complicated new currency that funds many a mortgage banker's operation? We asked some experts, and they say the way you slice up what you have to sell is very important. Getting just the right cross section will help fetch top dollar.

But sellers, it appears, need not worry about a shortage of buyers. A survey of 60 companies in this month's issue reveals that many servicers have aggressive plans to buy this year. Two-thirds of the surveyed companies replied to questions about their acquisition targets this year, and together they reported plans to add between 764,000 and 981,000 loans to their portfolios. At the root of these servicing expansion plans appears to be excess capacity. Excess capacity was a dirty word not so long ago, when it was used to describe what was wrong with the production side of the business. But when it comes to servicing, excess capacity means you have made the necessary investments to substantially grow your servicing business, which is good, the experts say. Because when you become a big servicer, those vaunted economies of scale come into play and reduce your per-unit servicing costs, unless you get too big, of course, and then you may be back to square one.

ARM servicing has its own unique problems. Because it is tough to do and, typically, more costly, buyer demand is limited. On top of that, payment-adjustment errors have been kicking up lawsuits and the wrath of regulators, which is something many would understandably rather avoid.

Janet Reilley Hewitt
Editor in Chief

COMING IN JULY

In July, we scope out what is driving the regulators to crack down so severely on commercial real estate loans. Next month our entire issue is devoted to a wide range of topics in commercial real estate finance.

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ARM SERVICING

An Exotic Species

ILLUSTRATION BY JEANNE TURNER

ARM servicing behaves in ways that make it less attractive to many servicers. Higher prepayments and more frequent foreclosures are typical for these portfolios, and that has depressed prices and sidelined some potential buyers.

Stephen Z. Hoff

If you ask most purchasers of mortgage servicing how they value ARMs, the answer you will probably hear is: "We don't." Many buyers in the market for servicing have little or no interest in ARMs. For example, one of the top five mortgage bankers reports that out of a portfolio of 575,000 loans, only about 1 percent are ARMs. A user-generated database compiled by McDash Analytics of about 4 million loans, consisting of the residential loan portfolios of 25 mortgage lenders, contains only 7.25 percent of ARM loans.

The McDash database is made up of regional and national lenders; approximately half hold servicing portfolios of 100,000 loans or more, and half hold 100,000 loans or less. Approximately 40 percent of the lenders in the database are mortgage bankers; 35 percent are thrifts; and 25 percent are banks.

The market's reluctance to buy ARM servicing is based on a number of factors including the perception of high payoffs, higher servicing costs resulting from periodic rate adjustments and the potential litigation expense associated with miscalculation of the rate adjustment. The Government Accounting Office published a study last year in which it estimated that as many as 25 percent of all ARM adjustments are calculated incorrectly.

Although adjustments began to appear in home loans as early as the late 1970s in California as variable-rate mortgages (VRMs) gained acceptance, mortgage loans with adjustable-rate features (ARMs) only emerged as an important market force in the U.S. single-family real estate market in the early 1980s. During that period of extremely high interest rates and an unusually high degree of rate volatility, ARM products offered a more attractive means of financing a home purchase. In addition, ARMs typically offered a discounted initial interest rate, which enabled more borrowers to qualify for the size loan they sought.

As ARMs became more popular in the early 1980s and thrifts became the dominant originators of ARMs, the Federal Home Loan Bank Board (FHLBB) touted ARMs as the preferred means of managing interest-rate risk. In theory, ARMs would largely mitigate the thrift industry's increasingly difficult dilemma of having long-term assets funded by short-term liabilities (savings deposits). This

problem was particularly acute in the newly deregulated financial environment, where it was not uncommon for thrifts' short-term cost-of-funds to significantly exceed their yield on the mortgages held in portfolio. It was also thought that an additional advantage of ARMs would be their ability to survive periods of heavy refinancing.

ARM production

The popularity of ARMs engendered a push by lenders who relied on the sale of ARM production to secondary market agencies to have the agencies and the FHA make these products available for secondary sale. The agencies responded, but not aggressively. FHA offered a limited amount of ARM product that had characteristics that were not considered highly attractive. Fannie Mae began purchasing ARMs for portfolio in 1980. Subsequently, Fannie Mae, Freddie Mac and GNMA offered adjustable-rate mortgage-backed securities (MBS) backed by ARM product. MBSs have also been offered in a senior/subordinated structure, whereby the thrifts' retention of the junior piece in portfolio also served to insure the senior piece. Lately, the agencies have developed innovative MBS structures that offer better pricing for ARM product than heretofore had been available. Freddie Mac, for example, offers a weighted-average coupon (WAC) ARM program that has allowed mortgage lenders greater flexibility in the diversity of ARM products that can be pooled.

Of the approximately 185,000 residential loans originated by McDash participants last year, about 23,000 or 2.4 percent were ARMs.

Characteristics

ARMs have been offered in a variety of forms. The basic characteristics of all ARM loans are:

Initial rate—The note rate offered for an initial period, typically one year. When offered at an artificially low rate, it is usually referred to as a teaser rate.

Index—The market-determined interest rate that forms the basis for subsequent adjustments. The most popular indices are the Federal Home Loan Bank's eleventh district cost-of-funds and U.S. Treasury security constants.

Spread over index (margin)—The increment added to the index that is used to determine the note rate in all but the initial period. This margin typically ranges from 250 basis points to 300 basis points.

Adjustment period—The interval between adjustments of the note rate. Adjustment intervals typically range from one month to five years.

Interest rate adjustment cap—The maximum allowable upward adjustment of the note rate in any single adjustment period, typically 1 to 2 percent per adjustment.

Life-of-loan rate-increase cap—The maximum allowable upward adjustment of the note rate over the life of the loan, usually 6 percent.

An additional feature of certain ARM programs is a convertibility option whereby the borrower can, at a pre-specified time, (for example, after 5 years), convert the loan to a fixed-rate instrument. The fixed rate attainable by the borrower at that time is typically specified as about a half point in excess of the market rate at the time of conversion. The existence of this feature has a number of ramifications, the most important of which is a lower anticipated prepayment rate.

Lately, the agencies have developed innovative MBS structures that offer better pricing for ARM product than heretofore had been available.

Valuation

Techniques used in the valuation of ARM servicing portfolios are similar to those used to evaluate fixed-rate portfolios. The value of the portfolio is computed by projecting revenues, less expenses and taxes, adding in amortization (a non-cash expense) and computing the present value of the expected after-tax cash flows generated by the portfolio over its projected life.

The key differences among valuation parameters between ARMs and fixed-rate mortgages involve assumptions about run-off rates, servicing costs, foreclosure rates and servicing fees. In three of the four primary determinants of the portfolio's cash flow stream, ARMs are perceived to be significantly inferior to comparable fixed-rate product. ARMs are typically subject to higher prepayment rates (see Table 1), costlier to service and suffer higher delinquency/foreclosure rates (see Table 2).

These disadvantages are not offset by any concessions in the fourth major factor: servicing fees. ARM servicing fees are generally the same as that of their fixed-rate counterparts. As a result, the cash-flow value of ARM portfolios often comes to only 60 to 70 percent of the value of a comparable fixed-rate package, although in certain interest rate environments, the servicing on ARM loans can trade at less than 50 percent of the value of fixed-rate mortgage servicing.

There is some controversy about how quickly ARM loans pay off, but the general consensus is that ARMs pay off at a much more rapid rate than fixed-rate mortgages. There is anecdotal evidence that during the rapid decline in interest rates experienced in the early 1980s, ARM portfolios were paying off at approximately 33 percent per year. Most servicers did not anticipate the high rate of ARM prepayments and were shocked at the surge in prepayments in their ARM portfolios during the 1986 to 1987 refinance boom.

This was the result of a miscalculation of consumers' motives in choosing ARM financing. Rather than being satisfied with a reduction in their note rate (and monthly payment) when rates fell, many ARM borrowers preferred to lock into a fixed-rate loan. Also, borrowers who intended to relocate within two to three years chose to take advantage of teaser rate ARMs rather than commit to fixed-rate product, even in low interest rate environments. However, a substantial portion of ARM borrowers chose to keep their original ARMs; avoiding high refinancing costs while also experiencing a significant reduction in their note rate.

ARM behavior

There are a number of theories to explain the rapid payoff characteristics of ARMs. First, a flat or inverted yield curve would cause fully indexed ARM rates to approach or exceed the rates of fixed-rate mortgages. Because borrowers seem to have a strong, natural preference for fixed-rate financing, this would cause borrowers to refinance into fixed-rate mortgages.

Second, ARM indices, because they are based on averages, tend to lag rate movements when the yield curve shifts downward. During the last major bond rally that ended in early 1987, long-term rates fell so quickly that ARM borrowers found that it was possible to refinance into fixed-rate mortgages at a lower rate than what they were experiencing at the current, fully indexed rate.

Third, ARM borrowers are often more mobile. Many home purchasers who do not expect to remain in a house for more than two or three years find it more cost effective to borrow at an adjustable rate, especially if there is a teaser involved. They believe that by the time the rate adjusts they will have already moved on to a different home and a different mortgage loan.

Finally, under certain circumstances, the borrower may find it advantageous to pay off a fully indexed ARM and refinance into another adjustable-rate loan with an attractive teaser rate even if there are no plans to move. For example, one New England lender is currently offering a one-year ARM with an initial rate of 5.5 percent with a two/six cap. This attractive pricing creates a strong incentive for borrowers to refinance.

Another concern among servicers is the higher unit-servicing costs anticipated for ARMs, especially those with negative amortization, short adjustment intervals and the relatively few that have adjustable servicing fees. Early on, many firms had to process ARM loans manually. This resulted in a significantly higher unit-servicing cost. The unit-cost increment was estimated by some at an one-eighth of a point of outstanding principal balance. Today some servicers estimate that ARMs are no more costly to service than fixed-rate product, due to the enhancement of their systems to accommodate ARM requirements.

Fears about ARMs' higher degree of vulnerability to foreclosure appear, in retrospect, to have been somewhat exaggerated.

The majority, however, still believe that unit servicing costs are higher for ARMs than for a comparable fixed-rate loan. Many secondary servicing market participants estimate the difference to be about $15 per loan. Because the majority of ARM loans are newer and have high average balances, the added cost has had a relatively minimal impact on the present value of the servicing.

Servicers perceived potential foreclosure risks associated with ARMs early on. With sufficiently large increases in interest rates, the loan could become unaffordable for the borrower. This risk would be exacerbated if the borrower had been qualified for the loan at an artificially low teaser rate, as was increasingly the case in the mid-1980s. This entails calculating the borrower's ability to meet the monthly payment obligations on the basis of the teaser rate rather than the fully indexed rate. This problem is made worse in the case of negatively amortizing loans, which can eventually reduce the borrower's equity to zero—or less.

Fears about ARMs' higher degree of vulnerability to foreclosure appear, in retrospect, to have been somewhat exaggerated. Table 2 indicates that ARMs suffer foreclosure at a rate roughly double that of conventional fixed-rate product. This may be a function of payment shock associated with the ARM rate becoming fully indexed. This is es-

TABLE 1

McDash Analytics, Inc.
Annualized Paid-In-Fulls and Foreclosure Completed Rates by State
(Only First Mortgages, Fixed Rate & ARMs)
For Month-End April 1990 thru March 1991

	Conventional Fixed Rate			Conventional ARMs		
Age of loans (yrs)	Average Loan Count	PIF Rate	FCC Rate	Average Loan Count	PIF Rate	FCC Rate
Total USA-All ages	1,177,175	7.96%	0.30%	216,627	12.10%	0.95%
California	288,942	8.79%	0.05%	58,242	18.35%	0.18%
Florida	73,746	7.85%	0.37%	20,777	8.68%	1.69%
Massachusetts	61,549	6.25%	0.08%	10,740	7.76%	0.61%
New Jersey	60,203	6.35%	0.10%	10,300	8.36%	0.21%
New York	68,842	6.78%	0.06%	13,748	5.68%	0.62%
Texas	127,160	7.58%	1.08%	14,806	6.86%	3.88%

(Data Reprinted with Permission of McDash Analytics)

TABLE 2

McDash Analytics, Inc.
Date as of March 31, 1991
RATIOS FOR THE MONTH OF MARCH, 1991

	CONVENTIONAL LOANS	
	FRMS	ARMS
LOAN COUNT	1,392,121	260,033
DELINQUENCY RATES		
1 Month	2.41%	3.30%
2 Month	.45%	.97%
3+ Months	.42%	1.01%
Total	**3.28%**	**5.28%**
IN FORECLOSURE	.43%	1.50%
IN BANKRUPTCY	.32%	.53%
Total	**.74%**	**2.03%**
Total Noncurrent	3.71%	6.78%
PAID IN FULLS		
Normal	.80%	1.37%
Foreclosures Completed	.03%	.10%
Total	**.83%**	**1.47%**

(Data Reprinted with Permission of McDash Analytics)

pecially a problem if the loan is underwritten on the basis of a teaser rate.

The conventional ARM foreclosure rate is still below that of fixed-rate FHA or VA mortgages. Nonetheless, there remains a fear that a sufficiently adverse interest-rate scenario could generate enough payment shock to cause severe ARM foreclosure problems.

Other factors that impact the valuation of ARM servicing are adjustable servicing fees, convertibility and liability resulting from improper rate adjustments. If the servicing fee fluctuates over time, this must be taken into account when modeling the cash flows. It is our experience that this added uncertainty is usually resolved to the detriment of the seller; the buyer will usually value the portfolio under the worst-case scenario (i.e. at the lowest available servicing fee).

Some ARMs are convertible to fixed-rate instruments. The likelihood is that if a potential purchaser viewed the probability of a conversion to be high, he or she would presumably modify the payoff assumption to reflect those currently being used for fixed-rate mortgages. Unfortunately, so little of this product exists, it is difficult to draw any hard conclusions about how the market actually modifies the evaluation.

Caveat ARM lender

An alarming rise in the number of lawsuits, including class-action suits, has occurred in the past few years based on incorrect ARM rate adjustments. One mortgage company settled a class-action suit for more than $1 million because a computer programmer used the wrong Treasury index from the list of key interest rates published by the Federal Reserve for ARM resets. The error was not discovered until an attorney for the borrowers brought it to the company's attention.

Houston-based Mortgage Consultants of America completed a number of ARM adjustment reviews in the past 12 months and reported an error ratio on ARM adjustments of 23 percent to 27 percent. Even though this ratio appears high, it must be noted that this percentage includes errors favorable to both the borrower and the lender. Of these errors, only about 8.5 percent were material errors requiring a mandated adjustment of more than $50.

Most errors result from the use of inaccurate or inappropriate indexes and incorrect adjustment dates that were found to result from set-up errors and general errors in the servicers' database documentation. Needless to say, when performing due diligence on an ARM servicing portfolio, it is important to analyze the adjustment calculations carefully.

The market

ARM servicing typically appears on the market as a segment of a larger overall portfolio. When separate, pure ARM portfolios do appear, they are typically agency product. Relatively little private investor ARM product is traded. A typical, entirely ARM servicing package would range between $50 million to $100 million in unpaid principal balance.

Although thrifts are by far the largest ARM producers, mortgage bankers are the primary sellers of ARM servicing. A great majority of ARM production volume was originated by thrifts for portfolio investment purposes and was not securitized.

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Thus, the percentage of total ARM mortgage debt outstanding that is easily tradeable on the secondary servicing market is relatively small, constituting only about 5 percent of servicing transfers, or about $7 billion of an estimated 1989 total servicing transfer volume of about $150 billion. Though thrifts also sell ARM servicing, they tend to sell only the servicing of securitized agency or Fannie Mae portfolio product. Because proceeds from the sale of servicing of whole loans in portfolio cannot be recognized up front, but must be booked over the life of the underlying asset, the sale of the servicing rights to thrifts' ARM loans held in portfolio is virtually never contemplated.

Typical ARM servicing buyers are large servicing operations or smaller shops that have developed specialized systems and therefore have a comparative advantage in servicing ARM product. Many firms do not have the systems in place to service ARMs efficiently. Also, the greater uncertainty regarding runoff, additional servicing costs and potential liability resulting from improper rate adjustments keeps many potential buyers on the sidelines.

Pricing

ARM servicing trades at significantly lower prices than comparable fixed-rate product, often selling for prices of only 60 to 70 percent of comparable fixed-rate servicing, depending on the interest rate environment. The major reason for this significant pricing difference appears to be the perceived higher prepayment risk of ARMs and, to a lesser extent, the servicing cost differential. Homogeneous packages of the more common ARMs with popular adjustment periods and indices (for example, one-year ARMs, indexed to Treasury bills), typically attain the best prices. Also, buyers offer higher prices for portfolios in certain geographic areas and for those with convertible options because they expect a lower prepayment rate. In terms of size, small- to medium-size packages of $50 million to $100 million have tended to get the best reception from the market.

–Prices for ARM servicing also are considerably more volatile than for fixed-rate product. ARM prices are extremely sensitive to anticipated prepayment rates, which in turn are greatly affected by the level of interest rates and the slope of the yield curve. For example, in the rising interest rate environment of early 1988, ARM portfolios attained prices of four times servicing fees (compared with the 4½ to 5½ times servicing fee multiple for fixed-rate portfolios.) However, when the yield curve flattened and then inverted in late 1988, ARM prices dropped to around two times servicing fees. Although prices for fixed-rate portfolios also fell somewhat, the percentage decline was nowhere near that experienced with ARMs.

By mid-1989, when the yield curve went from inverted to flat, ARM servicing prices went back to the 2½ to 3½ times servicing fee range. The fact that the ARM market is thinner, with fewer potential buyers than the fixed-rate market, also adds to its price volatility. ARM servicing typically sells for about two times service fee today.

ARM prices tend to strengthen when buyers anticipate relatively little runoff (i.e. when they perceive that interest rates will remain steady or rise)

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and when the yield curve is expected to remain positively sloped. On the other hand, abrupt interest rate declines or an inverted yield curve lead to a high level of ARM refinances. Buyers adjust by increasing their prepayment rate expectations, often to three or four times Public Securities Association (PSA) rate or more. The result is a drop in the value they place on ARM portfolios. A very steep, positively sloped yield curve can also cause prepayment concerns for ARM servicers, because a large spread between a fully indexed ARM interest rate and a current teaser rate may cause borrowers to refinance their existing ARMs into cheaper ARMs.

Conclusion

Since the mid-1980s, ARMs have constituted a large percentage of total, single-family mortgage loan origination volume. In high interest rate periods their share of the market often exceeds 50 percent. By some estimates, the ARM share of total single-family mortgage debt outstanding exceeds 20 percent.

Based on the McDash statistics in Table 1 and Table 2, one may conclude that in certain geographic areas, prepayment rates for ARMs are comparable to prepayment rates for fixed-rate mortgages. During the last 12 months, for example, New York and Texas experienced ARM payoffs at a rate that was actually less than that for fixed-rate mortgages. This data, of course, must be interpreted in light of the level and slope of the yield curve for that time period and the economic condition of the relevant geographic market.

Based on the last 12 months' prepayment data, it appears that for at least certain geographic areas, the market may be underestimating the average life of ARMs. To the extent that this is case, it seems reasonable to assume that an opportunity exists for those willing to commit the necessary resources to become efficient servicers of ARM loans and to develop the information needed to identify pricing anomalies in the marketplace. **MB**

Steven Z. Hoff is president and CEO of Hamilton, Carter, Smith Consulting Inc., based in Alexandria, Virginia.

The preceding text is adapted from Adjustable Rate Mortgages and Mortgage-Backed Securities *published by Business One Erwin.*

CANADA'S RISING STAR

The Canadian MBS is showing some real staying power, and investors are finding a lot to like about this thriving securities market.

Albert Warson

In little more than four years, the mortgage-backed securities (MBS) market in Canada has achieved growing stature in a way that seems impervious to the jarring shifts of the investment playing field.

MBS issues backed by the federal government of Canada have racked up sales of $5 billion from the time they were introduced in 1983 to the end of last year, according to Doug Hughes, a Canadian MBS expert. Despite 1991's lackluster market, sales as of May had already topped $6 billion.

Hughes is formerly the general manager of the Canada's Mortgage-Backed Securities Center operated by the Canada Mortgage and Housing Corporation (Cannie Mae), the federal government's housing agency located in Toronto. Cannie Mae is also the administrator for the Canadian mortgage-backed securities program. Thus, the agency may be described as a kind of Canadian hybrid of both FHA and GNMA in the United States.

Securitized, residential first-mortgage loans are insured by Cannie Mae and are originated by banks, trust companies, credit unions and mortgage brokers and are then combined into pools for sale to investors. Cannie Mae guarantees full and timely payment of principal and interest to the MBS investor. When MBS are issued, the mortgages are converted into fully guaranteed, flexible and liquid instruments. Each MBS represents an undivided interest in a pool of mortgages.

Although U.S. and Canadian mortgage-backed securities are structured in much the same way, there are differences in the standard mortgage terms and prepayment penalties (see Table 1).

Given the total $225 billion in Canadian residential mortgage loan debt, $6 billion in securitized debt is, comparatively speaking, insignificant. But at the rate MBS issued in Canada have skyrocketed—the growth curve practically forms a 45-degree angle—some industry sources' predictions that they will become the largest single source of residential loan funding by the year 2000 doesn't seem the least bit fanciful.

Meeting housing's need

In the early 1980s, the Canadian federal government saw that there was a pressing need to lower interest rates and help provide affordable housing for its citizens. During that period's 22 percent interest rate environment, Cannie Mae's role was expanded through an amendment of the National Housing Act (NHA) to provide the unconditional guarantee of timely payment when pools of government-insured mortgages were created. In taking this step, Cannie Mae looked to accomplish three broad objectives: to lower interest rates in general, to accomplish the return of long-term mortgage financing and to facilitate the smooth functioning of a secondary mortgage market.

In 1987, Cannie Mae began its guarantee program on MBS pools of residential, government-insured, first mortgage loans. Later the guarantee was expanded to include guarantees on MBS of two types of mortgages: regular and social housing pools. MBS on social housing pools were first issued in 1988, and they consist of mortgages of government-subsidized social housing projects. The key feature of these mortgages is the elimination of prepayment—making them an attractive security for investors.

Other parties had joined the MBS market as well. In 1985, GMC Investors Corporation in Toronto began issuing securities called Guaranteed Mortgage Certificates (GMC) that were guaranteed by Citibank Canada, a subsidiary of Citicorp. At that time, company President Ivan Wahl said that U.S. mortgage-backed securities had become the most popular investment instruments in Wall Street history and claimed that "the GMC will be as successful in Canada [as Ginnie Maes are in the U.S.]."

The GMCs had limited potential, but in general, mortgage-backed securities were catching on fast—especial-

TABLE 1

Comparison of U.S. and Canadian MB

	Ginnie Mae	Canadian MBS
Standard Mortgage Terms		
Standard term	30 years	5 years
Standard amortization	30 years	25 years
Principal due at maturity	0	94% of orig. balance
First prepayment date	Immediate	After 3 years
Prepayment Penalties		
Full prepayment	None	3 months interest
Partial prepayment:		
Amount allowed	Unlimited	10% minimum
Penalty	None	None

ly those carrying the Cannie Mae guarantee. Toronto-based FirstLine Trust, which Wahl now heads up, began issuing Cannie Mae-backed securities in 1987. Cannie Mae sources say sales have picked up steadily since then, and FirstLine issuances accounted for more than 30 percent of the total Canadian MBS issuance in 1990, according to Burns Fry, Limited, a Canadian investment firm.

Banks take the plunge too

The mortgage-backed securities market has seen a radical change in attitude on the part of investors in the last six months or so. For example, in an interview late last year, Wahl told *Mortgage Banking* that Canada's chartered banks were preoccupied with shaky, third-world real estate and corporate loans and only halfheartedly dabble in MBS. Cannie Mae data reflected that; at the end of 1990, trust companies held a 76.7 percent grip on investment market share. Banks had a 20.1 percent share, and life insurance companies had 3.2 percent share of investment.

Since then, however, banks have lunged into this investment pool with both feet. According to Cannie Mae, in February, banks' share of the market rose to 45.7 percent—nearly doubling in two months—and trust companies' share was reduced to 54.3 percent of the market for Cannie Mae-backed securities.

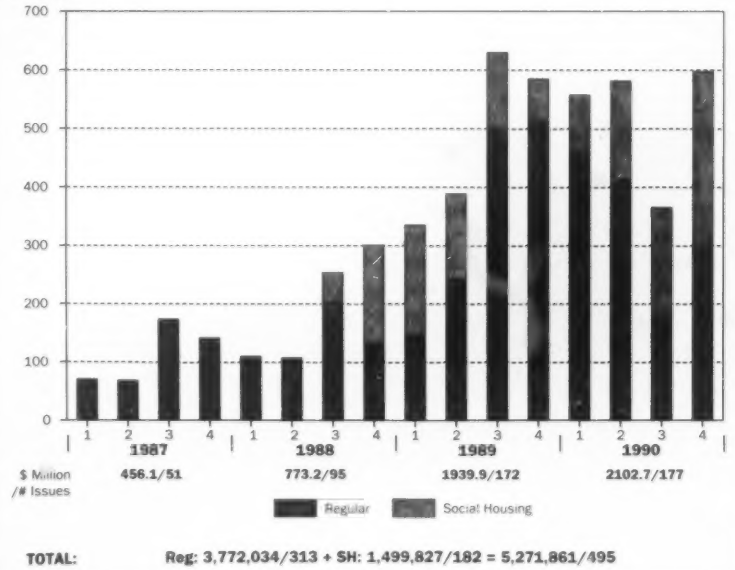
Why have the banks come alive so abruptly? Banks discovered that trust companies tended to stay away from MBS social housing pools. The banks were "stuffed with cash and realized they had to acquire assets, because loans on single-family housing had shrunk," said Hughes. Because banks were left with deposits they had to invest, they chose securities that backed mortgages on viable social housing projects where the mortgages were insured by Cannie Mae.

Therefore, rather than lose the business, banks have decided to take a 15 basis point spread, instead of the usual 200 basis points, Hughes said, and are now investing in social housing MBS to have those assets on their books. They can also use this investment to strengthen their community relations efforts.

Thus, what started as a program to provide shelter for low-income households has taken off as an attractive investment opportunity. In 1989, more than half a billion dollars in lower-cost financing for this housing sector was generated on the strength of its non-prepayable, fixed rate of return appeal to investors. Social housing pools provided bond equivalent yields of approximately 10.1 percent as of April 30, 1991. At year-end 1990, the percentage of social housing MBS was nearly half of the total government-backed issuances, with approximately $294 million issued in the fourth quarter alone, according to Cannie Mae (see Chart 1). Of the two types of MBS, prepayable and non-prepayable, the social housing mortgages fall into the non-prepayable MBS category. These can be compared to the government-insured prepayable MBS that provide for 10 percent prepayments on the principal at the first and second anniversaries of the mortgage and on any amount after the third anniversary. A three-month interest penalty is imposed, however, even on the prepayable mortgage.

CHART 1

Mortgage-Backed Securities
Inception–December 1990



TOTAL: **Reg: 3,772,034/313 + SH: 1,499,827/182 = 5,271,861/495**

Profile: FirstLine—a market leader

Several trust companies give FirstLine a competitive run in the prepayable market. On the other hand, Wahl says financial institutions, with huge staffs and overlapping layers of bureaucracies, "don't perceive MBS as a window of opportunity. They are not set up internally to make it worth the effort." FirstLine has designed its operations to track mortgage commitments, interest rate exposure, the bond market and many other administrative details, says Wahl. Its management says the company's success as an issuer of MBS is evidence that it has been well "worth the effort."

Wahl says FirstLine hopes to increase the size of its franchise network. Currently the network consists of 13 mortgage centers that originate product across Canada. Wahl plans on increasing the number of centers in the network to 50 by the end of 1991.

FirstLine also buys large blocks of mortgages from provincial govern-

ments that want to get out of non-profit rental housing loans. The company has purchased more than $460 million of these kinds of portfolios over the past three years from three provincial governments.

By charging 120 basis points as a yield on its investment vehicles such as its large mortgage portfolio, Wahl said FirstLine covers its overhead and makes a profit.

Market picture is bright

Cannie Mae data show that MBS produce higher yields than Government of Canada (GOC) bonds. During the third quarter of 1990, for example, the spread over GOC equivalent yields were 75 basis points for social housing (closed) MBS pools, 85 basis points for five-year, market residential (open) pools and 100 basis points for a 10-year term. Closed pools are those in which the borrower does not have the option to prepay principal. These securities, therefore, offer more predictable prepayment behavior, which makes them attractive to investors. Open pools consist of mortgages where the borrower has prepayment privileges, which are passed on to the investor when exercised.

Recent revisions to Cannie Mae-backed MBS include a fully open, 10-year, 10 percent rate buy-down mortgage that was marketed by a Toronto-area home builder in conjunction with the MBS program. (The usual Cannie Mae mortgage term is one to five years, with the first three years closed.)

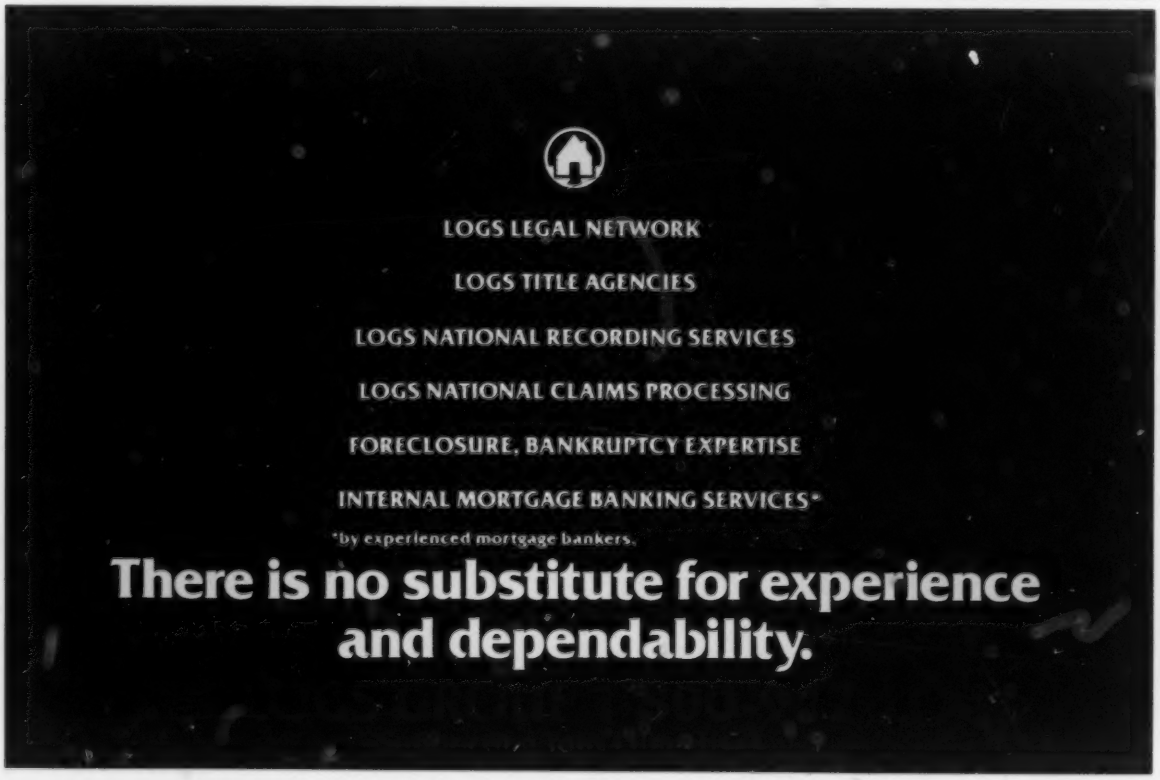
In September 1990, Cannie Mae responded to market pressures and reduced the minimum eligible mortgage term for MBS. After lenders reported how popular these mortgages were with their customers, the Cannie Mae policy was changed so the term could be as low as six months, down from four-and-a-half years. This also had the effect of encouraging more capital market participants to originate funds at a lower cost. Are these shorter-length terms popular with investors? "Yes" says a source at Cannie Mae, although the shortest-term mortgage securitized as of this spring has been a 10-month term, according to the agency.

The wider range of terms in the Canadian secondary market is intended to stimulate efficiency and liquidity of mortgage markets by attracting more investors. The terms also help reduce interest rate risk for financial institutions, increase the number of issuers, make more mortgage funds available at lower rates and open up access to homeownership.

"MBS have been enormously successful in the United States over the past 20 years and in Canada over the past four. Even in the United Kingdom, where the approach to business is quite different, the building societies, as they call lenders over there, are beginning to wake up to their potential," says Wahl.

Canada is currently considering a number of programs and products for inclusion in the already proven and successful MBS program. Sales of Canadian MBS have ben noted domestically as well as in the United States, Hong Kong and other international markets. The future of this burgeoning market will no doubt be watched with interest by its financial market neighbor to the south, along with the rest of the world. **MB**

Albert Warson is a Toronto-based writer and editor specializing in real estate development issues.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VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY	SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC ARMs	FHLMC FRMs
APR-90	55	5.4	4.7	4.8	10.53	8.55	10.37
MAY-90	440	5.3	4.4	4.8	10.49	8.59	10.48
JUN-90	212	5.3	4.7	4.9	10.21	8.49	10.16
JUL-90	−89	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−127	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−1	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−180	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−267	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−161	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−191	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−286	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−241	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−124	6.6	NA	NA	NA	7.38	9.49

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
APR-90	8.26	8.30	7.84	8.40	8.78	8.79	10.09
MAY-90	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN-90	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.19	6.07	5.71	6.24	7.23	8.04	9.46

CURRENT SECONDARY MARKET YIELDS (%)

	GNMA[2]	FNMA[2]	FHLMC[2]	SPREADS (Basis Points) GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
APR-90	10.01	9.94	9.94	122	115	115
MAY-90	9.99	9.93	9.92	123	117	116
JUN-90	9.73	9.73	9.72	125	125	124
JUL-90	9.66	9.66	9.66	119	119	119
AUG-90	9.80	9.75	9.75	105	100	100
SEP-90	9.86	9.79	9.73	97	90	84
OCT-90	9.84	9.80	9.69	112	108	97
NOV-90	9.63	9.66	9.54	124	127	115
DEC-90	9.22	9.27	9.16	114	119	108
JAN-91	9.17	9.24	9.12	108	115	103
FEB-91	8.81	8.86	8.77	96	101	92
MAR-91	9.00	9.03	8.93	89	92	82
APR-91	8.95	8.98	8.88	91	94	84

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
APR-90	35,407	7,543	12,400	15,122	28	1,973	145	935	698	50	18,984	100	621	14,796	3,048
MAY-90	37,255	9,420	13,183	14,231	27	2,453	297	1,061	874	39	15,412	110	640	10,905	2,657
JUN-90	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL-90	35,524	9,627	12,020	13,461	30	2,082	165	871	696	209	16,222	98	476	12,525	2,984
AUG-90	35,777	10,359	12,940	12,032	34	2,582	106	950	1,243	92	18,967	107	650	14,783	2,994
SEP-90	34,210	9,825	10,617	13,347	36	2,008	178	855	698	112	20,231	102	577	16,100	3,343
OCT-90	35,229	12,128	11,317	11,395	37	1,719	41	843	606	28	13,941	99	551	10,049	3,041
NOV-90	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
APR-90	1,217	952	265	1,108	870	238	124	283	467	343	120	238	423	327
MAY-90	1,208	935	273	1,065	853	212	128	255	486	339	124	218	410	313
JUN-90	1,187	931	256	1,108	844	264	114	241	532	300	121	224	428	335
JUL-90	1,155	907	248	1,082	838	244	115	226	492	322	111	227	428	316
AUG-90	1,131	865	266	1,050	818	232	122	240	434	335	112	225	402	311
SEP-90	1,106	893	213	992	786	206	104	239	445	318	104	221	386	281
OCT-90	1,026	861	165	920	751	169	144	290	392	260	113	200	354	253
NOV-90	1,130	823	307	906	713	193	147	232	483	268	105	195	367	239
DEC-90	971	768	203	844	688	156	110	233	395	233	100	178	337	229
JAN-91	847	677	170	797	647	150	86	167	361	233	96	182	309	210
FEB-91	993	820	173	863	735	128	90	303	388	212	95	204	345	219
MAR-91	901	760	141	884	728	156	97	223	393	188	98	203	339	244
APR-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
APR-90	3,370	95.7	534	130.0	8.3
MAY-90	3,350	95.2	535	125.0	8.2
JUN-90	3,370	98.9	549	125.0	7.9
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	409	120.0	9.4
FEB-91	3,160	94.0	485	120.0	8.0
MAR-91	3,180	96.5	490	125.0	7.5
APR-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
APR-90	308.9	109.3	18.6	94.6
MAY-90	303.9	105.7	19.1	93.5
JUN-90	299.1	101.8	17.0	95.4
JUL-90	298.5	99.9	16.9	98.4
AUG-90	290.5	97.6	16.9	93.2
SEP-90	286.1	95.1	16.7	91.9
OCT-90	279.3	93.5	17.0	89.2
NOV-90	272.4	90.6	16.0	86.8
DEC-90	267.0	87.7	16.6	86.7
JAN-91	264.2	82.6	15.7	86.3
FEB-91	260.0	79.5	15.2	86.6
MAR-91	256.8	77.6	15.3	83.4
APR-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1]Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2]Securities for 0- to 30-day delivery.

[3]In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4]Savings & Loans and Mutual Savings Banks.

[5]In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.